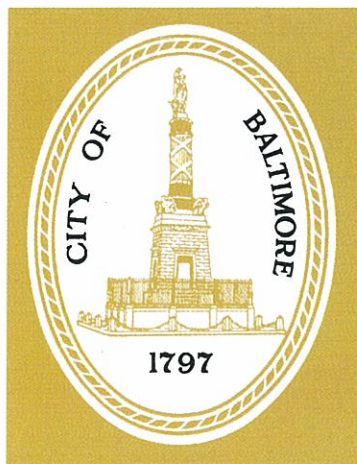

Review of
Water and Waste Water
Proposed Rate Increases
Effective May 2008



City of Baltimore
Department of Audits

April 8, 2008

Honorable Joan M. Pratt, Comptroller
And Other Members of the
Board of Estimates
City of Baltimore

We have reviewed the methodology and procedures used to determine the proposed 4% Water Utility Fund and 4% Waste Water Utility Fund rate increases submitted for the Board of Estimates' approval by the Department of Public Works (DPW) and the Director of Finance. The effective date of the proposed rate increases is anticipated to be May 22, 2008. The purpose of our review was to determine whether the methodology and procedures used to establish the proposed rate increases were reasonable and whether the applicable computations were accurate.

As required by the December 1978 Charter Amendment, the City Council adopted Ordinance 941, which established, among other things, a mechanism for the determination of rates and charges for water and waste water services. Ordinance 941 requires that the City's Water and Waste Water Utility Funds (Utilities) establish or adjust rates to make the Utilities self-supporting. Ordinance 941 also requires that the rates be established at a level sufficient to recover any accumulated deficit from prior years. Additionally, the Utilities must comply with revenue bond covenants that cover the utility rates.

The City entered into a Consent Decree with the United States Environmental Protection Agency and Justice Department, and the Maryland Department of the Environment in 2002 to address past and periodic discharges and wet weather overflows from the City's Waste Water collection system. As part of the Consent Decree, the City must significantly increase and accelerate its existing Capital Improvement Program (CIP) for the Waste Water System.

In order to determine the need for the proposed rate increases, Utilities' personnel prepared a comprehensive financial model that projects revenues, expenditures, cash balances and reserves for fiscal years 2008 through 2014. The projected revenue requirements and proposed rate increases are based upon expected operating expenses, CIP projects, sources of funds and legal covenant requirements. The proposed 4% Water and 4% Waste Water rate increases will increase revenues for fiscal year 2009 by \$3.0 million for the Water Fund and \$4.0 million for the Waste Water Fund. The proposed rate increases provide more reserve funds than required to meet expected legal covenants and required bond coverage through fiscal year 2009. However, according to Utilities' personnel, the additional reserve funds make the Utilities' revenue bonds more attractive to investors, resulting in more favorable interest rates when bonds are sold.

According to the Utilities' comprehensive financial model, annual rate increases for fiscal years 2010 through 2014 are expected to be 9%.

Based on our review of the methodology and procedures used to calculate the proposed rate increases, and our review of DPW's projections of revenues, expenditures, cash balances and reserves, the proposed 4% Water Utility Fund and 4% Waste Water Utility Fund rate increases appear reasonable. However, since the comprehensive financial model indicates that annual increases of 9% are expected for fiscal years 2010 through 2014, we encourage DPW to continue to look for other cost-saving measures that would reduce any future rate increases. Additionally, we recommend that future proposed rate increases be determined on an annual basis.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read "Robert L. McCarty, Jr.", is written over the typed name.

Robert L. McCarty, Jr., CPA
City Auditor